



HARVARD UNIVERSITY

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Andrew K. Semmel
Executive Director
U.S.- China Commission
444 North Capitol St. NW, Suite 602
Washington, DC 20001

Dear Mr. Semmel:

I respond to your request to comment on Gordon Chang's estimates of China's capital needs found in the paper he prepared for the US-China Security Review Commission.

Once the hyperbole is suppressed, Chang's paper contains much of value. It is a somber, up-to-date assessment of the problems confronting China's economic policy-makers, containing much useful information. But it abounds in "crises," "unsustainabilities," "inevitabilities," and looming disasters that add color but distract from the underlying analysis.

While Chang identifies well China's many economic problems, his quantitative forecasts are difficult to interpret. He forecasts GDP growth for 2002-2005 (Table 2.5) at an average rate of 3.5 percent from 2001. This marks a great slowdown from the 7-8 percent official growth rates of the preceding four years. He notes the widespread skepticism with the official figures, but does not offer his own for 1997-2001. The reader is not told whether his forecast growth relates to the official figures or to some lower estimate of actual growth rates in the preceding period. Thus the paper does not tell the reader how great the slowdown will be, or indeed (on a pessimistic interpretation of actual 1997-2001 growth rates) whether there is a slowdown at all. While Chang's text speaks of "stagnation" (p.1-11), and identifies WTO-generated import competition and (implausible) slower rural-urban migration as potential negatives, it is unclear what factors will result in a halving of growth rates during the next four years.

You asked me to address Chang's discussion of China's "capital needs," which I take to refer to the expenditure projections in his chapter 4. Here Chang projects Chinese government expenditures, revenue, and deficits for 2002-2005 (Table 4.1). Again, it is difficult to relate Chang's projections to the recent past, since he does not give his base line for the recent past. Official Chinese figures (as adapted to international concepts by the International Monetary Fund, and converted into US dollars) place China's total government expenditures at \$192 billion in 2000, for instance; this compares with Chang's \$331 billion for 2002. The latest



1737 CAMBRIDGE STREET
CAMBRIDGE, MA 02138
phone (617) 495-4420
fax (617) 495-8292
<http://data.fas.harvard.edu/cfia>

information I have for "extra-budgetary" revenues, mainly at provincial and local level and presumably roughly equal to expenditures, is \$37 billion for 1998, which goes only a small way toward closing the gap. Chang says forthrightly (p.4-2) that the figures he uses "are the result of guesswork and intuition rather than precise estimation." That makes it difficult for other observers to assess his forecasts. However, his estimated expenditure of \$331 billion for 2002 is comfortably within a projection of official 2000 expenditures, plus an estimate for extra-budgetary expenditures, extrapolated to 2002 at recent rates of expenditure growth.

Another way to approach the issue is to ask what percent of GDP (as reported by the IMF) is devoted to government expenditures (G). This was 22.8 percent in 2000 (including an estimate for extra-budgetary expenditures). This figure is consistent with that in other countries at China's level of development. Chang's figures imply a sharp jump to 27.4 percent in 2002 (see table below). The jump arises because Chang implicitly has government expenditures growing at recent rates, but GDP growth slows significantly. For the same reasons, Chang has G/GDP rising to 32.8 percent by 2005 – a figure that is high by international standards for countries as poor as China. The sharp growth in G/GDP by ten percentage points, from 23 percent in 2000 to nearly 33 percent in 2005, is possible but in my judgment implausible, given China's history of relative fiscal conservatism.

It is even more implausible on the basis of Chang's projections of government revenues. These fall from 24.2 percent of GDP in 2002 (Chang's revenue figure, my estimate of GDP using Chang's growth rate for 2002) to 20.8 percent in 2005 (i.e. back nearly to my 20.0 percent estimate for 2000). In combination with Chang's projected rise in expenditures, this implies a government deficit in 2005 of 12 percent of GDP, a result way outside the range of Chinese experience in recent decades.

It is not at all clear why revenues should decline – in Chang's projections, absolutely (\$277 billion in 2005 versus \$293 billion in 2002) as well as relative to GDP. He mentions "stagnation," of the economy, even though it is still growing, at 2.7 percent in 2005 on his forecast. He also mentions a decline in revenue as a result of tariff reductions resulting from WTO accession. It is true that China must reduce its schedule of tariffs by about fifty percent between 2001 and 2007. But China has provided many special tariff exemptions, so it did not collect the full scheduled tariffs in 2001. Under WTO, many of the special tariff exemptions must be phased out. Furthermore, Chang (along with many other observers) foresees a surge in imports under WTO membership (which however does not come fully into effect until 2007, beyond Chang's period of projection). Any such surge will raise import duty revenues, not lower them. A best guess is that import duty revenue will be higher in 2005 than in 2000, despite (or in part because of) the decline in tariff rates.

The decline in revenues foreseen by Chang is extremely implausible. If however revenues were to decline by that much, the rise in expenditures he projects is implausible, given China's relative fiscal conservatism, even allowing for the fact that Chinese officials have become more relaxed about government borrowing than they once were.

One point about government expenditures is worth special attention. Chang allows \$34.5 billion for recapitalization of the banks in 2004 and 2005. He is certainly correct in arguing that the banks need to be recapitalized, although the exact timing and amounts remain conjectural at this stage. (\$34.5 billion amounts to about 3.4 percent of GDP in 2000;

non-performing loans were officially acknowledged to be over 25 percent of GDP, and private estimates place them closer to fifty percent.) But this expenditure is a purely financial transaction, not a call on the output of the country, so it falls in a different category from most other government expenditures.

On Chang's projections the government deficit rises from 3.2 percent of GDP in 2002 to 12.0 percent in 2005. He has a puzzling discussion about the means for financing such a deficit (pp.4-(3-6)). There is a straight-forward method to finance deficits in China, which Chang reaches only after eliminating less obvious alternatives. It is to float domestic bonds, which at an appropriate interest rate it will have no trouble selling to the high-saving Chinese public, either directly or indirectly through financial institutions, mainly banks. The Chinese public today has limited vehicles for their high saving, mainly bank deposits. Even if, as Chang foresees, China has difficulty developing a fund-generating equity market, the reasons largely do not apply to government bonds. China's public debt remains low by international standards, and could continue to grow modestly more rapidly than GDP for a number of years. A deficit of 12 percent of GDP of course would raise the debt/GDP rapidly, but for reasons given above China's public deficit is unlikely to reach this magnitude.

I hope these comments are helpful to you.

Sincerely yours,

Richard N. Cooper

Richard N. Cooper

Professor of Economics

	2002	2003	2004	2005
			(percent)	
Expenditure/GDP*	27.4	29.0	32.6	32.8
Revenue/GDP	24.2	24.2	22.5	20.8
Deficit/GDP	3.2	4.8	10.1	12.0

*GDP of 2000 augmented by official growth rate for 2001 and Chang growth rate for 2002.